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5th Circuit decision further undermines use of administrative courts for SEC enforcement actions and provides fresh ammunition to SEC rulemaking challenges

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On May 18, 2022, the U.S. Court of Appeals for the 5th Circuit issued a 2-1 ruling in *Jarkesy v. SEC* finding the SEC's own administrative proceedings (APs) to be unconstitutional on multiple grounds. In the wake of numerous constitutional challenges in the past few years, the SEC has largely stopped bringing contested actions alleging substantive violations of the federal securities laws in the AP forum in favor of federal district court, so the decision has limited practical effect on the SEC's current enforcement program.

Historically, the SEC brought APs almost exclusively against entities and individuals registered to work in the securities industry, including broker-dealers and investment advisors.

But litigants will attempt to use *Jarkesy* to challenge the constitutionality of other kinds of proceedings — like so-called "follow-on" proceedings where the SEC seeks to bar individuals from participating in the securities industry as a result of criminal convictions or civil injunctions — that the SEC can currently only bring in an administrative forum.

And the decision may be a harbinger of a broader-scale effort to neuter the administrative state in the wake of growing skepticism in certain quarters of Congress and the federal judiciary of its perceived runaway growth and regulatory overreach.

Background

The SEC's Division of Enforcement, charged with investigating potential securities law violations and recommending certain dispositions (including settlements and litigation) to the agency's five-member Commission for approval, has discretion to determine whether to recommend filing certain kinds of litigated cases in either federal district court or in the SEC's own administrative proceedings.

APs are heard by an administrative law judge (ALJ). Litigants in APs have fewer procedural and discovery rights than defendants in civil actions brought in district court.

For example, defendants (called respondents in the AP context) have no right to a jury trial and are entitled only to limited depositions and other discovery, the Federal Rules of Evidence are not binding, and appeals are first made to the Commission, the body that authorized the enforcement action, before ultimately being subject to appeal in a federal appellate court.

Historically, the SEC brought APs almost exclusively against entities and individuals registered to work in the securities industry, including broker-dealers and investment advisors.

In the wake of the 2008 financial crisis, however, Congress expanded the SEC's authority through the Dodd-Frank Act, allowing it to bring APs alleging violations of the federal securities laws against, and impose civil penalties on, virtually anyone. The SEC responded by bringing more APs, which led to an increase in public attention and criticisms of the AP process as unfair, with a number of defendants challenging the legality of APs.

In 2018, the Supreme Court struck a blow against APs in *Lucia v. SEC*, holding that the appointment process for ALJs was unconstitutional.[1] This led the SEC to stay all pending administrative proceedings, and, ultimately, the Commission began to hear APs directly without the first level of ALJ review.

In addition, as a practical matter, the SEC began filing contested enforcement actions — those alleging substantive violations of the federal securities laws that were not resolved via settlement — largely, if not entirely, in district court.

This meant that the SEC continued to bring only a subset of claims in APs, namely those it could not bring in district court, such as

actions seeking bars from industry association or dealing in penny stocks, actions seeking bars for lawyers and accountants from practicing before the Commission, actions to revoke the registration of issuers who are delinquent in their required filings, and actions to temporarily stop trading in a class of securities.

5th Circuit ruling in *Jarkesy*

In 2011, well before *Lucia*, the SEC began investigating, and later instituted administrative proceedings against Jarkesy and Patriot28, alleging fraud arising from misrepresentations about and overvaluations of the assets relating to two hedge funds.

After a hearing, an ALJ found Jarkesy and Patriot28 liable, a finding the Commission later affirmed, and they were ordered to cease and desist from future violations and to pay $300,000 in civil penalties and $685,000 in disgorgement of monetary gains obtained through their alleged violations.[2] Jarkesy was also barred from participating in various securities industry activities.

Jarkesy and Patriot28 appealed the order to the 5th Circuit, raising a number of constitutional challenges. On May 18, a two-judge majority of the 5th Circuit agreed with them, finding the SEC's administrative proceedings against Jarkesy and Patriot28 unconstitutional on three grounds.[3]

First, the Court held that Jarkesy and Patriot28 had been deprived of their right to a jury trial under the Seventh Amendment.[4] The Court applied a two-part test: (1) whether the suit was of a type that could have been brought at "common law" at the time of the Seventh Amendment's adoption (in 1791); and (2) whether, in any event, such an action did not require a jury right because it "may be properly assigned to agency adjudication under the public rights doctrine."[5]

The Court found that this enforcement action was like those arising at common law since it is akin to fraud prosecutions that were brought in English courts at the time of America's founding.[6]

Critically, the Court held that actions like this one seeking civil penalties are akin to special actions in debt, which the Supreme Court has recognized are a distinctly legal claim.[7] As a result, the Court held that a jury trial right attached to this action "because of the civil penalties sought."[8]

While the Court acknowledged that other remedies sought by the SEC, such as disgorgement and industry bars, were equitable remedies for which no jury right historically attached, it held that "the penalty facet of the action" meant that defendants had a right to a jury "adjudication of the underlying facts supporting fraud liability."[9]

After concluding that jury rights typically attached to the types of claims alleged, the Court then determined that the SEC's enforcement action may not "properly [be] assigned to agency adjudication under the public rights doctrine" because fraud actions historically have been adjudicated by common-law courts, and requiring them to be brought before a jury in federal court would not upset the statutory regime of the securities laws because, after all, the SEC had done so for years and Congress had specifically given it the power to do so.[10]

Second, the Court found that Congress unconstitutionally delegated legislative power to the SEC by giving it "unfettered authority" to bring the securities fraud enforcement action for penalties against Jarkesy and Patriot28 in either an Article III court or in an AP, without providing the SEC an "intelligible principle by which to exercise that power," because "a total absence of guidance is impermissible under the Constitution."[11]

If the 5th Circuit is correct that power has been unconstitutionally delegated to the SEC, the decision could have an effect on the agency's rule-making ability under the non-delegation doctrine.

Finally, the Court found that the restrictions on the removal of ALJs violate Article II of the Constitution because the President cannot directly remove ALJs. Instead, ALJs can only be removed by the Commission "for cause," and in turn the President can remove individual Commissioners only "for cause."

Because "ALJs are insulated from the President by at least two layers of for-cause protection from removal," the President is unconstitutionally deprived of the ability to oversee the ALJs in order to "take care" that the laws are faithfully executed.[12]

Takeaways

The SEC can, and likely will, seek a rehearing of *Jarkesy* by the 5th Circuit *en banc*.

If the decision ultimately stands, however, its effect may be more significant beyond the narrow (albeit important) world of the SEC's enforcement program.

- **SEC enforcement generally**: As a practical matter, the decision will not impact the vast majority of substantive SEC enforcement actions since they are currently all litigated in federal district court. Nor will it disturb the common practice of having the Commission approve negotiated settlements in lieu of having a federal court judge doing so. If anything, the opinion will only further entrench the SEC's current practice. As Chair Gary Gensler and other SEC leaders continue to state their desire for more aggressive enforcement and more litigated enforcement actions, they may start to chafe at the slower pace and more resource-intensive nature of district court litigation and begin to advocate for Congressional fixes to some, if not all, of the problems identified in *Jarkesy*.
- **SEC APs**: It remains an open question whether defendants will be able to challenge SEC proceedings that can only be brought in an administrative forum. The 5th Circuit ruled that the defendants were entitled to have a jury "adjudicate the facts underlying any potential fraud liability that justifies penalties." But follow-on APs are typically based on the imposition of a district court judgment against the defendant and therefore do

not involve fact-finding as to liability. There is some precedent holding that in certain contexts equitable remedies, such as disgorgement and industry bars, may be penal.[13] Future defendants could argue that such remedies also implicate jury trial rights. But any argument challenging follow-on proceedings would face obstacles, including unfavorable precedent, not the least of which is the 5th Circuit's own reasoning in *Jarkesy* indicating that actions for disgorgement and industry bars are not actions "at law."[14]

- **SEC regulatory regime**: If the 5th Circuit is correct that power has been unconstitutionally delegated to the SEC, the decision could have an effect on the agency's rule-making ability under the non-delegation doctrine, which could lead to challenges to rules promulgated by the SEC. But such challenges could be difficult to win: the 5th Circuit rested its ruling on the fact — conceded by the SEC — that the congressional delegation of authority to decide when to use the AP forum for securities fraud penalty actions contained *no* principles at all to guide the delegation. By contrast, as the 5th Circuit noted, the Supreme Court has upheld extremely broad delegations of rule-making authority to agencies, including the SEC, even where the guiding principle is as broad as acting in the "public interest."[15] On the other hand, the composition of the Supreme Court has changed significantly since many of those cases were decided, and the 5th Circuit panel may have extended an invitation to the Supreme Court to reconsider past precedent and revive the non-delegation doctrine.[16] And, if the SEC does not prevail before an *en banc* 5th Circuit, it likely will seek a legislative fix for (at least) the delegation issue.
- **Regulatory state generally**: *Jarkesy* could also affect the regulatory state more broadly. The 5th Circuit's holdings are relevant to other federal agencies who use administrative proceedings — specifically those who seek penalties in enforcement actions or have ALJs who are subject to similar limits on removal. Similarly, there could be challenges to the delegated authority of federal rule-making agencies, even though a federal grant of authority has not been invalidated since 1935, to the extent that this opinion marks a revival of the delegation doctrine. We might even see some defendants who were previously sanctioned in APs file lawsuits to overturn their cases based on the holdings in *Jarkesy*, which is what happened after *Lucia*. The SEC, however, will be loath to review affected APs due to the considerable drain on its resources, especially as it pursues an aggressive enforcement agenda that is already stretching its capabilities. Observers should expect the SEC to fight hard to overturn or mitigate the effect of *Jarkesy*, both through the courts and in Congress. In fact, it is also likely that the *Jarkesy* decision will be the basis for a future certiorari petition to the Supreme Court — which already has agreed to hear two cases for the 2022-23 term regarding jurisdictional issues related to the constitutionality of administrative proceedings — because of its potential effects on the administrative state generally.[17]

Notes

[1] *Lucia v. SEC*, 138 S. Ct. 2044 (2018).

[2] Order of the Securities and Exchange Commission No. 3-15255.

[3] *Jarkesy v. SEC*, No. 20-61007, 2022 WL 1563613 (5th Cir. May 18, 2022).

[4] *Id*. at *4.

[5] *Id*. at *11.

[6] *Id*. at *9 (citation omitted).

[7] *Id*. (citing *Tull v. United States*, 481 U.S. 412, 418-19 (1987)).

[8] *Id*. at *10.

[9] *Id*. at *11.

[10] *Id*. at *11-14 (citations omitted).

[11] *Id*. at *25 (citing *Gundy v. United States*, 139 S. Ct. 2116, 2123 (2019)).

[12] For further discussion, *see* Cleary Gottlieb, Alert Memorandum, "Supreme Court Holds that SEC Administrative Law Judges Are Unconstitutionally Appointed" (June 26, 2018), available at https://bit.ly/3u2mfdJ.

[13] *See, e.g., Kokesh v. S.E.C.*, 137 S. Ct. 1635 (2017) (holding that disgorgement is a penalty for purposes of the statute of limitations proscribed in 28 U.S.C § 2462 because it sought to redress a wrong to the public rather than an individual and to deter others from violating public laws "as opposed to compensating a victim for his loss."); *Johnson v. SEC*, 87 F.3d 484, 489 (D.C. Cir. 1996) (holding that a censure and six-month suspension was a penalty because the bar had been imposed solely in view of the defendant's misconduct and not because of unfitness or public risk).

[14] *Jarkesy*, 2022 WL 1563613 at *11. The Supreme Court and other courts have declined to extend Kokesh a number of times. *See, e.g., Liu v. SEC*, 140 S. Ct. 1936 (2020) (declining to extend Kokesh and finding that disgorgement functions as an equitable remedy under the Exchange Act); *Saad v. SEC*, 980 F.3d 103, 108 (D.C. Cir. 2020) (declining to extend Kokesh to statutory provisions other than § 2462 where broker-dealer had been permanently barred by FINRA); *SEC v. Gentile*, 939 F.3d 549 (3d Cir. 2019) (holding that "obey the law" injunctions that are narrowly tailored to a preventive purpose and industry bars in SEC enforcement actions are not penalties subject to § 2462); *SEC v. Collyard*, 861 F.3d 760 (8th Cir. 2017) (finding that the injunction at issue was not a penalty, in part, because it was imposed to protect the public and therefore was not subject to § 2462).

[15] *Jarkesy*, 2022 WL 1563613 at *24 (citing *Whitman v. Am. Trucking Ass'ns, Inc.*, 531 U.S. 457, 474-75 (2001)).

[16] For instance, the 5th Circuit cited approvingly to Justice Gorsuch's dissenting opinion in *Gundy v. United States*, 139 S.Ct. 2116, 2134 (2019), in which the justice sought to limit delegations of authority to agencies. If Justice Gorsuch's Gundy dissent were to become the view of a Supreme Court majority, it could significantly curtail current broad rulemaking efforts by the SEC and other agencies.

[17] The first case in which the Supreme Court granted certiorari for the 2022-23 term, *Axon Enterprise, Inc. v. FTC*, will require the justices to decide what jurisdiction district courts have to hear constitutional challenges to the FTC's administrative proceeding structure and procedures before the administrative proceedings have concluded. *Axon Enter. v. FTC*, 986 F.3d 1173 (9th Cir. 2021), cert. granted in part, 142 S. Ct. 895 (2022). The other case, *Cochran v. SEC*, is another 5th Circuit ruling which focuses on the jurisdiction of district courts to adjudicate constitutional challenges to ongoing SEC administrative proceedings. Specifically, Cochran sought to challenge the constitutionality of ALJ removal protections under Article II of the Constitution, which is an argument *Jarkesy* resolves directly. *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021) (en banc), *cert. granted sub nom.*, 2022 WL 1528373 (May 16, 2022).

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